

**Letter Report: The Implementation of a New  
Audit Selection Program for Earned Income  
Credit Filers Could Result in Significant  
Taxpayer Burden**

**July 2001**

**Reference Number: 2001-40-102**

**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

July 24, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Letter Report – The Implementation of a New Audit  
Selection Program for Earned Income Credit Filers Could Result  
in Significant Taxpayer Burden

This report presents the results of our review to determine if the use of Department of Health and Human Services' (HHS) data provided to the Internal Revenue Service (IRS) would improve its ability to identify taxpayers who may have claimed the Earned Income Credit (EIC) in error. In summary, we found that the IRS is implementing a new audit selection program that will negatively affect the EIC audit program. Specifically, the originally planned use of the new program would exempt almost 31 percent of taxpayers who claim the EIC from selection for an audit under the program. In addition, 24 percent of those taxpayers who are selected for audit under the new program would be burdened with a needless audit that resulted in no change to the EIC claim, which is a 50 percent increase in the number of no-change audits over the old selection program.

While management agreed with our recommendations in the report, they questioned our outcome measures concerning taxpayer burden and increased revenue loss. Specifically, management disagreed with the 24 percent no change rate that we calculated and the fact that the new audit selection program would exempt almost 31 percent of taxpayers that claim the EIC. Management cited that the analysis was flawed. We have reviewed management's additional information, and in our opinion, our conclusions are reasonable. We have included both IRS management's concerns and our rebuttal on pages 8 and 9 of the report.

Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Walter Arrison, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

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### Objective and Scope

*The objective of this audit was to determine if the use of HHS data provided to the IRS would improve its ability to identify taxpayers who may have claimed the EIC in error.*

The objective of this audit was to determine if the use of Department of Health and Human Services (HHS) data provided to the Internal Revenue Service (IRS) would improve its ability to identify taxpayers who may have claimed the Earned Income Credit (EIC) in error. To achieve our objective, we:

- Determined if there is an impact on taxpayers and/or the IRS resulting from the use of incomplete HHS data provided to the IRS.
- Determined if the IRS validated the accuracy of audit results by reviewing 13<sup>1</sup> of the 1,428<sup>2</sup> audits for Tax Year (TY) 1999 that were closed by the IRS during its test in the Austin Tax Processing Center from March to September 2000. We reviewed the 13 audits to determine if the IRS had validated the accuracy of the HHS data.
- Determined if the IRS' criteria for selecting taxpayers for audit reduced burden by identifying those taxpayers with the highest potential for an erroneous EIC claim.
- Reviewed over 600 closed audit cases as of September 2000 and determined whether the required information was documented on cases where the IRS determined the taxpayers were entitled to their claim for EIC, which would enable the IRS to refine the case selection criteria.

We conducted work at the National Headquarters, the Austin Tax Processing Center, and the Gulf Coast District Office of Research and Analysis from October 2000 to February 2001. This audit was

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<sup>1</sup> Total number of closed cases which included the use of HHS data.

<sup>2</sup> Total number of cases in the test as of September 2000 that involved the HHS data was 3,689.

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performed in accordance with *Government Auditing Standards*.

Major contributors to this report are listed in Appendix I. Appendix II contains the Report Distribution List.

### Background

Erroneous EIC claims are a source of significant loss of revenue for the government. The IRS estimated that almost \$8 billion (27 percent) of \$30 billion in EIC claimed for TY 1997 were in error.<sup>3</sup> A main cause of these errors was taxpayers claiming a child who did not meet the qualifications for the EIC.

*The IRS does not have the necessary data to verify the EIC claims at the time tax returns are filed.*

Because the IRS does not require evidence to support that a qualifying child lives with the taxpayer, it does not have the necessary data to verify the EIC claim at the time a tax return is filed. As a result, when tax returns are filed and the IRS questions the EIC claims, taxpayers can be subjected to EIC audits,<sup>4</sup> which can be costly, time consuming, and intrusive.

Several years ago, the IRS developed a computer program that includes common characteristics of erroneous EIC claims to identify and select taxpayers for audit. This program screens all tax returns with a claim for the EIC at the time the tax returns are filed; each return is prioritized for those identifying characteristics that would indicate the taxpayer is not eligible for the EIC. The more characteristics identified, the greater the probability that the taxpayer is not entitled to the EIC claim.

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<sup>3</sup> The IRS' "Compliance Estimates for Earned Income Tax Credit on 1997 Returns," dated August 16, 2000.

<sup>4</sup> EIC audits are IRS audits of tax returns conducted through the mail, with the IRS typically asking taxpayers for more support regarding their claims for the EIC.

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*The TRA 97 included a provision that gave the Department of the Treasury access to data collected by the HHS.*

To improve the IRS' EIC audit identification process, the Congress passed the Taxpayer Relief Act of 1997 (TRA 97),<sup>5</sup> which included a provision that gave the Department of the Treasury access to data collected by the HHS. Data not available to the IRS prior to the implementation of that provision of TRA 97 included information about whom the child resided with (residence is a requirement to claim the EIC). The HHS data could help the IRS identify a child's residence for determining entitlement to an EIC claim. As a result, the IRS developed a new audit selection program to use the HHS data to identify potentially erroneous EIC claims for audit.

During the 2001 tax return filing season, the IRS plans to select approximately 100,000 taxpayers for an EIC audit using this new program. These 100,000 taxpayers will have their tax refunds held for several months while the audits are being conducted and will be required to provide the IRS with extensive documentation to support their claims for the EIC.

### Results

*The new program could have a substantial negative impact on the EIC audit program.*

The IRS is implementing a new audit selection program that, if used as originally planned, would exempt almost 31 percent of taxpayers who claim the EIC from selection for an audit under that program, based solely on the state in which they reside. In addition, 24 percent<sup>6</sup> of the returns selected for audit under the new program would result in no change to the amount of EIC claimed by the taxpayer; this is a 50 percent increase over the no-change results of the older audit selection program.

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<sup>5</sup> Pub. L. No. 105-34, 111 Stat. 961 §§ 1090(a) and 1090(b).

<sup>6</sup> Percentage calculated by TIGTA based on preliminary results provided by the IRS' Gulf Coast District Office of Research and Analysis, dated November 2000.

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### Implementation of the New Audit Selection Program as Originally Designed Would Result in Significant Taxpayer Inequity and Burden

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Using data provided to the IRS by the HHS as the main criteria for selecting taxpayers for EIC audits would have a substantial negative impact on the EIC audit program. For the 2001 tax return filing season, the IRS plans to use two selection programs to identify taxpayers for EIC audits. Specifically, the IRS plans to select 100,000 returns (45 percent of the total EIC audits selected by these programs) for audit using the new audit selection program and 120,000 (55 percent) using the older selection program. Therefore, almost half of the taxpayers selected for an EIC audit using these programs for the 2001 tax return filing season will be affected by the issues identified in this audit report.

*Use of the new audit selection program as originally planned would exempt 31 percent of taxpayers claiming the EIC from being selected for an EIC audit.*

Prior to our audit, the IRS intended to use its new audit selection program in such a way that it would have exempted almost 31 percent of the EIC filing population from being selected for an EIC audit based solely on the state in which they reside. This results from the fact that data provided by the HHS do not include any child records from nine states and the District of Columbia (see table below). These 9 states and the District of Columbia account for 31 percent of EIC claimants nationwide. Therefore, almost 6 million taxpayers would receive inequitable preference based solely on an arbitrary characteristic unrelated to the custody status of the dependent(s) used to qualify them for the EIC claims.

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### States Missing Child Records From HHS Data

	States for Which No Child Record Data Are Provided	Number of Taxpayers Claiming the EIC for TY 1998 Residing in These States
1	Arizona	327,818
2	Georgia	680,128
3	Louisiana	464,304
4	Massachusetts	270,006
5	Michigan	539,932
6	New York	1,245,588
7	Vermont	35,367
8	Wyoming	31,457
9	California	2,240,988
10	District of Columbia	50,245
	Total EIC Filers for States not on HHS Data	5,885,833
	Total EIC Filers	18,756,110

Source: TIGTA Report: *Administration of the Earned Income Credit* (Reference Number 2000-40-160, dated September 2000) and IRS Information Systems.

After we discussed with IRS management our concern with their use of HHS data as the main determinant for audit selection in December 2000, they modified the method that will be used to select taxpayers under the new program. However, the main determinant of whether a taxpayer is selected for audit is still the existence or nonexistence of that taxpayer on the HHS database.

*The new audit selection program will result in a higher rate of unnecessary audits of entitled taxpayers.*

During the 2001 tax return filing season the IRS will perform audits of 100,000 taxpayers using the new audit selection program. If the IRS selected these 100,000 taxpayers using the older audit selection program, which uses common characteristics of erroneous EIC claims as a basis for selecting taxpayers for audit, an estimated 16,000 of the selected returns would be audited unnecessarily.<sup>7</sup> In comparison, under the new audit selection program 24,000 of the taxpayers selected

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<sup>7</sup> Based on figures provided by the IRS as of September 2000.



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would not experience a change to their EIC claim. Therefore, the new audit selection program will burden an estimated 8,000 additional taxpayers, as compared to the older audit selection program.

While the selection of some taxpayers for audit, who are entitled to the EIC claimed, is an unfortunate and, in our opinion, an inevitable effect of attempting to identify erroneous EIC claims, the IRS should strive to reduce the selection of entitled taxpayers to the largest extent possible.

Our analysis of audits from the Austin test where taxpayers were entitled to claim the EIC, suggested that the majority of those taxpayers would not have been selected for audit under the older selection program. Specifically, preliminary results from the IRS' test identified 685 entitled taxpayers who were selected for an EIC audit. When we matched these 685 taxpayers to the IRS' older selection program, we found that 668 (98 percent) of the 685 taxpayers would not have been selected for an EIC audit.

Two reasons the new audit selection program results in the exemption of almost 31 percent of EIC filers from audit and a higher selection of entitled taxpayers being audited are that the data provided by the HHS are incomplete and inaccurate. Specifically, these data (1) do not contain information from nine states and the District of Columbia (this issue was discussed in detail above) and (2) contain inaccuracies due to missing and/or outdated information. Some examples of the inaccuracies in the data are as follows:

- We found that in 8 of the 13 audits we sampled from the Austin test, the data from the HHS were inaccurate as to who was entitled to claim the child. Appendix IV provides examples of the situations involved in these cases and the burden that was placed on the taxpayers.
- As of October 2000, the IRS had received approximately 70,000 records that did not contain

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the social security numbers of the parents, making these records useless to the IRS.

- Many states do not provide the HHS with needed additions, changes, and deletions so that the data being compiled by the HHS can be updated and provided to the IRS. We identified one example of this in the cases we sampled from the Austin test.

IRS' Examination Policy Statement P-4-21 states that the primary objective in selecting taxpayers for examination (audit) is to promote the highest degree of voluntary compliance on the part of the taxpayers. This requires the exercise of professional judgment in selecting sufficient returns of all classes of tax returns in order to assure all taxpayers equitable consideration, in using available experience and statistics indicating the probability of substantial error, and in making the most efficient use of examination (audit) staffing and other resources.

*Use of the new audit selection program could have a serious negative impact on both taxpayers and the IRS.*

The selection of entitled taxpayers for audits results in the taxpayers' refunds being delayed an average of 6 months while the taxpayers go through the audit process. In addition, the IRS will lose the opportunity to audit taxpayers who actually have erroneously claimed the EIC. We estimate that the use of the new audit selection program will result in the IRS missing the opportunity to protect over \$22 million in revenue from truly erroneous EIC claimants.

### Recommendations

The following recommendations will address the issues identified in this report:

1. The Commissioner, Wage and Investment Division, should ensure that the HHS data are combined with the selection criteria from its original audit selection program to identify taxpayers for EIC audits. The use of this data should be monitored and results tracked to identify needed adjustments to the specific methodology of its use.

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Management's Response: Management will include the Electronic Fraud Detection System model in the Dependent Database (DDb) and will monitor DDb selection results during Processing Year (PY) 2002. An analysis of these results will be performed at the end of the PY 2002 audit process.

2. The Commissioner, Wage and Investment Division, should continue to coordinate with the HHS to obtain information from states that do not currently provide data. The Commissioner should also coordinate with the HHS to ensure a clear understanding of the development and updating processes for the data and to ensure that the data provided are as accurate as possible and that the IRS is aware of the characteristics and issues which affect their accuracy.

Management's Response: The Commissioner, Wage and Investment Division, continues to work with the HHS, Office of Child Support Enforcement, on the status of state reporting and definition and updating of elements. A meeting has been scheduled with the HHS to discuss the results of the DDb test for Federal Case Registry data.

Office of Audit Comment: While management agreed with our recommendations in the report, they questioned our outcome measures concerning taxpayer burden and increased revenue loss. Specifically, management disagreed with the 24 percent no change rate that we calculated and the fact that the new audit selection program would exempt almost 31 percent of taxpayers that claim the EIC. Management cited that the analysis was flawed for the reasons cited below. We have reviewed management's additional information, and in our opinion, the 24 percent no change rate is reasonable based on the following:

- A. TIGTA relied upon incomplete test information that was compared to established and tested criteria. The data used were the best and most current data that the IRS had available at the time of our audit. Management used this incomplete

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data in its two interim Dependent Database test reports: the Dependent Database Audit Study Interim Results, dated December 6, 2000, and the Interim Report-Dependent Database Application Test, dated February 21, 2001. The data were used to support the IRS' decision to implement the Dependent Database during the IRS' 2001 tax return filing season.

- B. The data TIGTA reviewed included cases surveyed and accepted as filed by screeners before initiated examinations. Of the 886 IRS audits that resulted in a no change decision, 88 audits were closed by IRS employees who concluded that the taxpayers should not have been selected for an audit. These 88 audits were included in our analysis because the IRS had selected them for audit. Management's subsequent actions after the cases were selected and reviewed were to conclude that these taxpayers should not have been selected for audit.
- C. TIGTA included rules for cases selected that did not contain the EIC. We used the rules in our calculation of the no change rate that management had used to select taxpayers for audit based on the HHS data. Specifically, management had used rules 1 through 5. In a presentation given to IRS top executives on December 6, 2000, to support using the Dependent Database during the IRS' 2001 tax return filing season, the IRS' Research Division noted that rules 1 through 5 were used to select taxpayers for audit based on the HHS-provided information. When management issued its subsequent Interim Report-Dependent Database Application Test, dated February 21, 2001, they concluded that rule 5 was no longer an HHS-based rule and would not be included in any future calculations that were performed for a no change rate. The IRS continues to use rule 5 and the HHS data to determine whether the taxpayer who claims the EIC is the custodial parent.

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Furthermore, management disagreed with the 31 percent figure that we calculated for the missing state data. They indicated in their response that an update from the HHS had been received in March 2001 which reduced the number of states where there is missing data to four rather than the nine states and the District of Columbia that we reported. While these data were not available for the IRS' use and in a useable format until April 3, 2001, we believe that the IRS has taken positive steps to obtain more complete information. It should continue to pursue the missing data from the other states to ensure that all taxpayers who claim the EIC are not excluded from selection for an audit under that program based solely on the state in which they reside.

### **Conclusion**

The IRS is implementing a new audit selection program that, if used as originally planned, would exempt almost 31 percent of taxpayers who claim the EIC from selection for an EIC audit under that program. In addition, 24 percent of those taxpayers who are selected for audit under this program would be entitled to the EIC claim. This represents an increase of 50 percent over the results of the older audit selection program, which resulted in 16 percent of the selected taxpayers being audited needlessly.

However, the HHS data contain information that could help the IRS identify a child's residence for determining entitlement to an EIC claim. Therefore, this information should be used as another characteristic in the IRS' selection of taxpayers for audit who may be erroneously claiming the EIC.

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**Appendix I**

**Major Contributors to This Report**

Walter E. Arrison, Assistant Inspector General Audit for Audit (Wage and Investment  
Income Programs)

Michael Phillips, Director

Russell Martin, Audit Manager

Pamela DeSimone, Senior Auditor

Robert Howes, Senior Auditor

Roberta Bruno, Auditor

Grace Terranova, Auditor

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**Appendix II**

**Report Distribution List**

Commissioner N:C  
Chief Information Officer IS  
Chief, Criminal Investigation CI  
Earned Income Tax Credit Program Manager W:EITC  
Director, Compliance W:CP  
Director, Refund Crimes CI:RC  
Director, Strategy and Finance W:S  
Chief Counsel CC  
Director, Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O  
Office of Management Controls N:CFO:F:M  
National Taxpayer Advocate TA  
Audit Liaisons:  
    Chief, Criminal Investigation CI  
    Earned Income Tax Credit Program Office W:EITC  
    Director, Compliance W:CP  
    Director, Refund Crimes CI:RC

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### Appendix III

#### Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

##### Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 8,000 taxpayer accounts affected; (see page 6).

##### Methodology Used to Measure the Reported Benefit:

The Internal Revenue Service's (IRS) current method of identifying taxpayers with erroneous claims for the Earned Income Credit (EIC) results in 16 percent<sup>1</sup> of the audits involving entitled taxpayers. The IRS plans to select 100,000 taxpayers for audit that filed a 2000 tax return claiming the EIC. Preliminary test results for the Department of Health and Human Services (HHS) data show that 24 percent of the audits involved entitled taxpayers.

TIGTA calculated the 24 percent using data provided by the IRS' Gulf Coast District Office of Research and Analysis dated November 2000, which included the preliminary results of the Austin test cases as of September 2000.<sup>2</sup> The 24 percent no change rate was computed by:

- Dividing the total number of audits where there was no change to the EIC amount by the universe of audits. ( $886/3,689 = 24$  percent).
- The volume of no change audits (886) was calculated as follows:
  1. Results from November 2000 data analysis identified 773 no change cases which included:

685      Audits performed with no change to the EIC amount claimed.

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<sup>1</sup> Based on figures provided by the IRS as of September 2000.

<sup>2</sup> At the time of this report, this was the only data available to us and the IRS to calculate the number of entitled taxpayers who were selected for an EIC audit based on the HHS data.



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- 88 Audits where the IRS selected the taxpayer, however, closed the case before initiating an audit.<sup>3</sup>
2. The remaining 113 no change cases (886 overall minus the 773 identified from data included in the November 2000 extract) was computed as followed:
    - As of the November 2000 data analysis, a total of 2,261 audits were still in progress (not closed). From this total we estimated that 5 percent<sup>4</sup> would result in a no change case totaling 113 cases.  $(2,261 * 5 \text{ percent} = 113)$ .
  3. 773 no change cases per the November 2000 data extract + 113 projected no change cases = 886 total cases with no change to the EIC amount claimed.

TIGTA calculated the 8,000 taxpayer accounts by:

- Subtracting the 16 percent no change rate for the current selection program from the 24 percent no change rate for the new selection program.  
(24 percent - 16 percent = 8 percent).

Multiplying the 100,000 audits planned for the new selection program by the difference in the no change rates of the current and the new selection programs of 8 percent.  
(100,000 \* 8 percent = 8,000).

### Type and Value of Outcome Measure:

- Increased Revenue Loss – Potential; \$22,288,000; (see page 7).

### Methodology Used to Measure the Reported Benefit:

The average amount of an EIC audit case that is disallowed under the current IRS selection method is \$2,786.<sup>5</sup>  $\$2,786 \times 8,000 = \$22,288,000$ . We estimate that the use of the new audit selection program will result in the IRS missing the opportunity to protect over \$22 million in revenue from truly erroneous EIC claimants.

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<sup>3</sup> These 88 cases were included in the no change calculation based on the IRS' District Office of Research and Analysis' direction on how to compute a no change rate for an audit program.

<sup>4</sup> The 5 percent was provided by the IRS' Remote Examination Function as the percentage of audits that can be estimated to result in a no change audit from the universe of open audits at this point in the audit process.

<sup>5</sup> Based on figures provided by the IRS as of September 2000.

**Additional Examples of Austin Test Cases That Involved Taxpayers Who Were Entitled to the Earned Income Credit**

*Case example:*

The Internal Revenue Service (IRS), based on data provided by the Department of Health and Human Services (HHS), identified that this taxpayer was not entitled to the Earned Income Credit (EIC). The taxpayer was able to provide documentation to show that he was the grandfather of the qualifying child who in fact lived with the grandfather. To prove he was entitled to the EIC, the grandfather was required to provide the IRS with rent and utility records, birth certificates, social security cards, and MEDICAID information.

*Case example:*

The IRS, based on data provided by the HHS, identified that this taxpayer was not entitled to the EIC. A third party, who was the boyfriend of the child's mother, made the EIC claim. To prove that he was entitled to the EIC, the taxpayer provided documentation to show that he was the father of the qualifying child who lived in his home. He also provided letters from his Certified Public Accountant and the mother of the child, signed letters from the school attended by the qualifying child, a utility bill, and a lease agreement.

*Case example:*

The IRS, based on data provided by the HHS, identified that this taxpayer was not entitled to the EIC. To prove that she was entitled to the EIC, the taxpayer provided documentation to show that she is the natural parent of twins and that the qualifying children lived with her. The mother provided birth certificates, social security cards, school records, and a letter from a utility company.

*Case example:*

The IRS, based on data provided by the HHS, identified that this taxpayer was not entitled to the EIC. The taxpayer is the grandmother of the qualifying child. To prove that she was entitled to the EIC, the taxpayer provided documentation to show that she is the grandmother and the qualifying child lived at her address. The taxpayer provided the birth certificates for both her own daughter and grandson, a signed letter from the school the grandson attended to show address, social security cards, a utility bill, a telephone company letter of credit, a mortgage payment statement with cancelled check, and the divorce decree of her daughter.

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### *Case example:*

The IRS, based on data provided by the HHS, identified that this taxpayer was not entitled to the EIC claim since he is a third party. The qualifying child is being claimed by this third party who is the child's uncle. To prove that he is entitled to the EIC, the taxpayer provided documentation to show that he is the uncle and the qualifying child lived at his address. The taxpayer provided a letter explaining his relationship, signed letters from the school attended by the qualifying child, a utility company billing inquiry, a water bill, social security cards, and a letter from the child's natural father.

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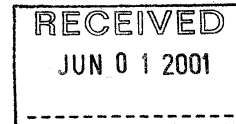
**Appendix V**

**Management's Response to the Draft Report**

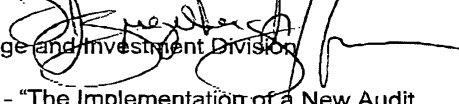


DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

May 31, 2001



MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX  
ADMINISTRATION

FROM: John M. Dalrymple   
Commissioner, Wage and Investment Division

SUBJECT: Draft Letter Report - "The Implementation of a New Audit  
Selection Program for Earned Income Credit Filers Could  
Result in Significant Taxpayer Burden" (Audit #2001-40-026)

We appreciate the opportunity to respond to your draft report "The Implementation of a New Audit Selection Program for Earned Income Credit Filers Could Result in Significant Taxpayer Burden." While we agree with the recommendations in the report, we do not agree with your Outcome Measures concerning taxpayer burden and increased revenue loss. The report does not accurately reflect the effectiveness of the Dependent Database (DDb) and the use of external data to help identify taxpayers who erroneously claim Earned Income Tax Credits (EITC).

The report calculated a no change rate of 24 percent for cases examined during the DDb test phase, using a check sheet analysis of data captured from March 2000 through September 2000. This analysis is flawed for several reasons:

- TIGTA relied upon incomplete test information that was compared to established and tested criteria;
- The data TIGTA reviewed included cases surveyed and accepted as filed by screeners before initiated examinations, and
- TIGTA included rules for cases selected that did not contain EITC.

We computed a no change rate of 16 percent for rules using Department of Health and Human Services (HHS) data, based upon data contained in the IRS Research "Interim Report – Dependent Database Application Test," dated February 21, 2001. TIGTA's methodology was followed, but we excluded survey/accepted as filed and non-EITC cases. This no change rate is comparable to the no change percentage for other EITC selection programs. Therefore, based on the above methodology, no revenue loss would be attributed to the DDb, as you specified in the Outcome Measures.

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We also analyzed information contained in the draft Research "EITC – DDb Audit Study Final Report", dated March 30, 2001, which shows the no change percentage for rules containing HHS information to be 18.7 percent. This percentage was determined utilizing data from the Audit Information Management System closed case database at the conclusion of the test period and is significantly lower than the 24 percent rate computed by TIGTA based on less reliable checksheet data.

The TIGTA report also states the "IRS is implementing a new audit selection program that, if used as originally planned, would exempt almost 31 percent of the taxpayers who claimed the EITC from the selection for an audit under that program, based solely on the state in which they reside." The TIGTA report concludes that 31 percent of the taxpayers would be eliminated because nine states and the District of Columbia did not report Federal Case Registry (FCR) information. In fact, HHS updates the FCR information with IRS twice a year. We received the most recent update in March 2001. We are now only missing data from four states and the District of Columbia. This, however, does not imply that we are not including taxpayers from these states in the overall EITC audit plan. Other EITC selection tools, including Electronic Fraud Detection System (EFDS), include taxpayers from all states. The addition of the FCR data to the selection process was intended to enhance case evaluation by providing additional information for consideration, in conjunction with internal information. It does not exclude taxpayers from the EITC Program.

The IRS never intended to use the DDb as its only source of selection for EITC audits. We developed the Fiscal Year (FY) 2001 EITC plan in March 2000, and we provided the campuses their examination work plan in June 2000. This included workload from both DDb and the EFDS, as well as other EITC receipts.

Additionally, all case examples in Appendix IV of the report (Attachment 1) were addressed through enhancements to the DDb selection process for the FY 2001 rollout.

Our comments on your recommendations are as follows:

### **IDENTITY OF RECOMMENDATION 1**

The Commissioner, Wage and Investment Division, should ensure that the HHS data is combined with the selection criteria from its original audit selection program to identify taxpayers for EITC audits. The use of this data should be monitored and results tracked to identify needed adjustments to the specific methodology of its use.

### **ASSESSMENT OF CAUSE**

The DDb was created to address a statutory requirement to utilize HHS data regarding child support. The system was designed to be used with existing EITC workload selection processes, not as a replacement system. Initially, we did not incorporate the

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EFDS scoring model into the DDb because we wanted results solely attributable to the DDb.

### **CORRECTIVE ACTION**

We will include the EFDS scoring model in the DDb for tax year 2001 processing to provide more efficient workload delivery.

### **IMPLEMENTATION DATE**

Proposed: January 1, 2002

### **RESPONSIBLE OFFICIAL**

Director, W&I Exam Strategy and Selection

### **CORRECTIVE ACTION MONITORING PLAN**

We will monitor DDb selection results during Processing Year (PY) 2002. Research will perform a complete analysis of DDb selects at the end of the PY 2002 audit process.

### **IDENTITY OF RECOMMENDATION 2**

The Commissioner, Wage and Investment Division should continue to coordinate with HHS to obtain data from states that do not currently provide data. The Commissioner should also coordinate with HHS to ensure a clear understanding of the development and updating processes for the data and to ensure that the data provided is as accurate as possible and that the IRS is aware of the characteristics and issues which affect their accuracy.

### **ASSESSMENT OF CAUSE**

As of 1999, state child support enforcement agencies must report information electronically on child support issues to HHS, Office of Child Support Enforcement. Some states initially encountered systems problems in complying with that requirement, but the number of states reporting continues to increase.

### **CORRECTIVE ACTION**

The Commissioner, Wage and Investment Division, continues to work with HHS, Office of Child Support Enforcement on the status of state reporting and definition and updating of data elements. We scheduled a meeting with HHS for May 31, 2001, to discuss the results of the DDb test for FCR data.

### **IMPLEMENTATION DATE**

Ongoing

### **RESPONSIBLE OFFICIAL**

National Program Manager, Earned Income Tax Credit Program

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### **CORRECTIVE ACTION MONITORING PLAN**

We will continue to monitor HHS data to track the status of all states reporting FCR data. We will also continue discussions on the definitions and updating of data elements.

If you have any questions about this response, please contact William Zachery, Director, Exam Strategy and Selection at (404) 338-7643, or members of your staff may contact Frank LoProto at (631) 447-4446.

Attachment

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### Attachment 1

We addressed the issues identified in Appendix IV by enhancing the system for the FY 2001 rollout.

**Case Examples 1 and 4** – These examples relate to grandparents and would not have fallen out in the national rollout because the test revealed deficiencies with these rules. We modified the national rollout for these rules to make a distinction between the ages of the primary taxpayer and the qualifying child found on the HHS data file.

**Case Example 2** – This example relates to a boyfriend claiming the qualifying child. The tax law definition of the foster child changed; therefore, this taxpayer would have been selected using the EFDS criteria and the DDb criteria.

**Case Example 3** – This example would have been selected under Rule 3. We modified Rule 3 to enhance the third party rule to include only HHS records with custodial information in the file.

**Case Example 5** – This example relates to an uncle claiming the child and would have been selected using the EFDS criteria and the DDb criteria. The taxpayer must prove the child lived with him for 12 months of the year.